

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 16th Floor
Sacramento, California 95814**

**NOTICE OF PROPOSED EMERGENCY AMENDMENT
PURSUANT TO CALIFORNIA INSURANCE CODE SECTION 12921.7**

California Earthquake Authority Policies, Coverage Types and Limits

File No. ER06050266

February 7, 2006

California Insurance Commissioner John Garamendi (the Commissioner) hereby provides notice pursuant to California Insurance Code section 12921.7 that he will submit for emergency amendment Title 10, Chapter 5, Subchapter 7.7, Section 2697.6 of the California Code of Regulations (10 CCR §2697.6) to the Office of Administrative Law for approval pursuant to California Government Code section 11346.1.

The emergency amendment (10 CCR §2697.6) implements, interprets, and makes specific Chapter 8.6 (commencing with section 10089.5) of Part 1 of Division 2 of the California Insurance Code [California Earthquake Authority].

This Notice includes a description of the problem that the amendment is intended to resolve, the necessity for the amendment, the justification for its emergency adoption, and a copy of the text of the emergency amendment.

This Notice will be provided to every person, group, and association who has previously filed a request for notice of all regulatory actions with the Department of Insurance (Department), as well as to every person, group, and association having filed a request to receive only notices of regulations specifically involving Property & Casualty, Rate Regulation, Discrimination and Underserved Communities.

Documents concerning this proceeding are available on the Department's website. To access them, go to <http://www.insurance.ca.gov>. Find, near the top of the leftmost column, the pull down menu under the heading "Quick Links." Select the "Legal Information" link. On the "Legal Information" page, click on the "Proposed Regulations" link. When the "Search or Browse for Documents for Proposed Regulations" screen appears, you may choose to find the documents either by conducting a search or by browsing for them by name.

To search, enter "ER06050266" (the Department's regulation file number for this amendment) in the search field. Alternatively, search using as your search term the California Insurance Code section number of a code section that the regulations implement (for instance, "10089.11"), or search by keyword ("earthquake," for example, or "CEA"). Then, click on the "Submit" button to display links to the various filing documents.

To browse, click on the "Browse All Regulations" button near the bottom of the screen. A list of the names of regulations for which documents are posted will appear.

Requests for hard copies of this Notice and questions regarding it should be directed to: Lisbeth Landsman-Smith, Staff Counsel, Department of Insurance, 300 Capitol Mall, Suite 1600, Sacramento, California, 95814, phone 916-492-3561, email: landsmanl@insurance.ca.gov.

This proposed emergency amendment will be submitted to the Office of Administrative Law not less than five (5) working days after the mailing of this Notice.

Description of Problem and Necessity for Regulation

The California Earthquake Authority ("CEA") was established by Legislative enactment. The CEA only writes the earthquake line of insurance and is managed as a public instrumentality of the State of California, but is funded mostly with private monies. Formed in response to the widespread unavailability of homeowners and earthquake insurance after the 1994 Northridge earthquake, the CEA considers one of its fundamental objectives to be increasing the availability of earthquake insurance.

The CEA writes a single policy of residential earthquake insurance, which has been divided through regulation into base-limits and supplemental-limits coverages. 19 insurers contract with the CEA to meet their legal mandate to offer earthquake coverage in California ("participating insurers"). CEA earthquake insurance is available only to California homeowners, condominium owners and renters who maintain certain types of policies with participating insurers. All such policyholders are eligible to purchase CEA earthquake coverage, but only about 13% of eligible homeowners, renters and condominium owners currently do so (about 750,000 policyholders). Before the creation of the CEA, such policyholders purchased earthquake coverage at two to three times this rate.

As recent catastrophic events have demonstrated (most prominently, Hurricane Katrina), the importance of widespread and adequate earthquake insurance coverage cannot be overstated. The CEA has been exploring ways to increase the number of policyholders who carry earthquake insurance. The CEA's research and public input have indicated that homeowners would strongly support more choices in supplemental-limits coverages, which in turn would make the CEA product more useful to them and therefore more attractive to purchase. Additionally, a review of the CEA's limited loss experience, from the date of its inception, suggests that its current base-limits building-code-upgrade coverage may not be sufficient. This proposed emergency amendment would both increase the flexibility of coverage options for current and future CEA policyholders and double the amount available for building-code-upgrade coverage.

On April 29, 2004, under authority granted by Insurance Code section 10089.7, the Governing Board of the CEA (whose voting members consist of the Governor, the Treasurer, and the Commissioner, or their designees) voted to approve further study of policy changes that included an increase in building-code-upgrade coverage and "unbundling" of the present supplemental-limits-coverage packages. The Governing Board ("Board"), at its August 25th 2005 meeting approved these items as part of a larger plan that also included a 22.8% overall statewide average

rate decrease for base limits coverages and adjusting the rating factors that are used to calculate the premium (“CEA plan”). As statutorily required, the CEA forwarded rate applications containing these policy changes to the Department for administrative approval. Certain changes to the base-limits coverages rates described in the rate applications were negotiated by the Department and CEA staff and were approved by the Board at its January 30, 2006 meeting. The rate applications are now pending final approval by the Department.

However, the Board’s action and the Department’s administrative approval are not alone sufficient for implementation of these policy changes. Insurance Code section 10089.11 (b) requires that the Commissioner promulgate regulations that define CEA coverage types and limits. Such regulations are in place, but the existing regulations do not authorize the aforementioned Board-approved policy changes. Therefore, in addition to the Board’s and Department’s approval, this regulatory amendment is required in order to implement the aforementioned policy changes.

Justification for Adoption of Emergency Regulation

In order to minimize disruption to insurers and policyholders, 10 CCR §2697.6 must be adopted as an emergency amendment because, as explained below, the standard rulemaking timetable in the Government Code is inconsistent with the timetable for rate approval in the Insurance Code. The only practical way to immediately protect the public’s interest in this case is to adopt the amendment on an emergency basis. Failure to do so will delay the ability of policyholders to add important insurance coverage for disasters and cause CEA participating insurers to apply inconsistent rating factors for CEA coverages.

Under Proposition 103 (Insurance Code sections 1861.01 et seq), insurers that issue property and casualty policies in California must submit their rate changes to the Department of Insurance for review and approval, and such rates cannot be unfairly discriminatory. The CEA is not exempt from these requirements. When Proposition 103 was passed by the voters in 1988, the CEA did not exist. But, CEA legislation specifically addressed Proposition 103 requirements by including Insurance Code sections 10089.11 and 10089.40. Section 10089.11 requires that regulations be promulgated to make the CEA’s rate approval and forms procedures “consistent with the requirements of Proposition 103,” and Section 10089.40 requires that the “[r]ates established by the authority shall be actuarially sound so as to not be excessive, inadequate, or unfairly discriminatory.” The regulations subsequently adopted under the authority of those sections contain provisions essentially identical to regulations promulgated under Proposition 103.

In addition to the Proposition 103 related provisions, Insurance Code section 10089.11 requires that CEA regulations be promulgated to “define coverage types and limits” for the CEA policy. This requirement is unique to the CEA and conflicts with the Proposition 103 rate approval process. That conflict is apparent here because, while the rate application process with the Department is nearly completed (pending final approval), the normal rulemaking process required for amendment of 10 CCR §2697.6 would take more than a few months to complete and would impede the CEA’s planned implementation schedule. Under the CEA’s plan new rates are scheduled to go in to effect on July 1, 2006. In order to accomplish this, the Insurance Code requires that participating insurers must mail notices to policyholders at least 45 days before then

(no later than May 17, 2006). From an operational standpoint, to accomplish this mailing, and provide for the re-rating of the 750,000 policies, computer programming by participating insurers must be completed roughly 30 to 45 days before May 17, 2006 (mid to early April 2006) to effect that mailing. But, as previously explained, final implementation cannot be accomplished until this amended regulation is adopted. Emergency amendment of the regulation will allow the CEA to implement its plan without interruption.

Without emergency amendment of 10 CCR §2679.6, several problems will arise. First, the CEA will not be able to implement the increased building-code-upgrade coverage shortly after the Department's approval of its rate applications because it lacks authority to offer that additional coverage. Additionally, the CEA will be forced to use rating factors for its base-limits coverages that are different from the supplemental-limits coverages rating factors. This discrepancy could subject the CEA to a charge that its rates are unfairly discriminatory under Insurance Code section 10089.40. Normally, the use of different rating factors violates the prohibition against unfair discrimination, except when the differences in rates, inter alia, are based on differences in risk or expenses. However, in this case the differences between the rating factors applicable to base-limits and supplemental-limits coverages would exist solely due to the lack of a regulation authorizing adjustment to the supplemental-limits coverages.

For example, the CEA's current rating factors for both base-limits and supplemental-limits coverages do not distinguish between a one-story house and a house with two or more stories. Risks are rated the same way, irrespective of whether the dwelling is one story or multiple stories. However, recent revisions to the CEA's earthquake-loss modeling show that multiple-story houses have greater risk for damage than single-story. The CEA's rate applications reflect this revision and contemplate simultaneous adjustment of the one-story vs. multiple-story rating factor for both base-limits coverages and supplemental-limits coverages. While, without a new rate filing, the CEA cannot change its rating for supplemental-limits coverages unless and until the emergency amendment is adopted, no regulatory change is needed for the base-limits coverages. Therefore, the rate adjustments for the base-limits coverages will take effect shortly after approval by the Department (aside from adjustments to building-code-upgrade rates). In view of the foregoing, the rating factors for the base-limits coverages will differ from the rating factors for the supplemental-limits coverages. As a result, the differences in the rating factors may be considered unfairly discriminatory.

Whether or not they would ultimately be held to be so, the CEA's use of different rating factors will cause tremendous confusion in the marketplace. CEA policyholders will not understand why their base-limits coverages are rated and priced differently from their supplemental-limits coverages and participating insurers serving policyholders will face enormous difficulties implementing the two inconsistent rating plans. This result can be best avoided by the adoption of the amended regulation on an emergency basis, which will allow adjustment of the rating factors to the base-limits and supplemental-limits coverages policies to occur simultaneously.

California's case law supports the Commissioner's decision to promulgate an emergency regulation in this instance. In Schenley Affiliated Brands Corp. v. Kirby, 21 Cal. App. 3d 177 (Cal. Ct. App. 1971), the court held that an agency did not abuse its discretion in promulgating emergency regulations where other regulations were about to go into effect and additional

regulations were needed in order to achieve a fully operational regulatory scheme. (See Doe v. Wilson, 57 Cal. App. 4th 296, 305-306 (Cal. Ct. App. 1997)). The court in Doe v. Wilson went on to cite, with approval Philadelphia Citizens in Action v. Schweiker (3d Cir. 1982) 669 F.2d 877, at 885-888, where regulations were authorized on an emergency basis because “new federal law had required states to comply within a period of 49 days, which was too short a period of time for the lengthy process of promulgation of administrative regulation on a nonemergency basis; and therefore the agency did not abuse its discretion in promulgating emergency regulations.” (See Doe v. Wilson, 57 Cal. App 4th at 307).

Here, Insurance Code sections 10089.11 and 10089.40 have created a similar situation. Pursuant to these statutes, the CEA’s planned increase in the current building-code-upgrade coverage and “unbundling” of the supplemental-limits coverages must be accomplished through a two part process: (1) rate applications with the Commissioner and (2) an amended regulation. Yet, as shown here, the rate application timeline and the ordinary rulemaking timeline do not coincide. In order to harmonize both regulatory schemes, the rate applications must be acted on within the time mandated and the policy changes required to be made by regulation must also be finished within that same timeframe. Accordingly, the Commissioner must shorten the regulatory process and utilize the emergency regulation procedures. Otherwise, as explained above, the coverage changes to be implemented will not occur in harmony with the effective date of the approved rate applications.

In summary, if the amended regulation is not adopted in conjunction with approval of the rate applications, only part of the CEA’s rating plan that is described in the pending rate applications can go in to effect. CEA policyholders will not be able to immediately increase their building code upgrade coverage. Additionally, CEA participating insurers would be forced to implement part of the CEA plan and then must repeat the implementation process once the amended regulation is adopted. Perhaps even more disrupting, existing policyholders will have their base-limits coverage priced using one set of rating factors (the rate application rating factors) and yet have their supplemental-limits coverage priced under a different set of rating factors (the current rating factors). As stated, this may violate the prohibition against unfair discrimination in rates. For the foregoing reasons, 10 CCR §2697.6 must be adopted as an emergency amendment.

Text of the Proposed Regulations to be Adopted

The proposed regulation text is attached.

**PROPOSED TEXT OF AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS,
TITLE 10, CHAPTER 5, SUBCHAPTER 7.7¹**

Section 2697.6. Earthquake Policies, Coverage Types and Limits.

(a) The Authority must offer, in accordance with the provisions of Division 2, Part 1, Chapter 8.5, of the Insurance Code, a basic residential earthquake insurance policy to any owner of a qualifying residential property, as long as the qualifying residential property meets the eligibility standards of the Authority and the owner has first secured a residential property insurance policy from a participating insurer.

(b) The Authority must renew any basic residential earthquake insurance policy it has written, provided that the Authority receives payment of the applicable renewal premium on or before the expiration date stated in the policy. The Authority must nonrenew, rescind, or cancel a policy on the grounds that the qualified residential property is no longer covered by an underlying residential property insurance policy issued by a participating insurer.

(c) No policy issued by the Authority will provide coverage in the event there is no underlying residential property insurance policy issued by a Participating Insurer at the time of loss. In that case, any unearned premium shall be returned to the policyholder on a pro rata basis.

(d) The types and coverage limits of Authority policies shall be as follows:

1.	Dwelling policy:	15% Deductible
	Coverage A (Dwelling)	Equal to the Coverage A (or its equivalent limit) of underlying residential property insurance
	Coverage B	Not available
	Coverage C (Personal Property)	\$5,000
	Coverage D (Loss of Use)	\$1,500
	Coverage E (Limited Building Code Upgrade)	\$10,000

The CEA may also, at its option, offer dwelling policyholders an additional \$10,000 in coverage for Limited Building Code Upgrade.

¹ Proposed amendments appear in *italicized* text and proposed deletions appear in ~~strickthrough~~ text.

2.	Individual condominium or cooperative unit policy:	15% Deductible
	Coverage A (Real Property)	\$25,000
	Coverage B	Not available
	Coverage C (Personal Property)	\$5,000
	Coverage D (Loss of Use)	\$1,500
	Coverage E (Limited Building Code Upgrade)	\$10,000
	Coverage F (Loss Assessment (condominium value > \$135,000))	\$50,000
	Coverage G (Loss Assessment (condominium value < \$135,000))	\$25,000 or \$50,000
3.	Renter's policy:	15% Deductible
	Coverage A	Not applicable
	Coverage B	Not applicable
	Coverage C (Personal Property)	\$5,000
	Coverage D (Loss of Use)	\$1,500

(e) In issuing its optional-limits basic residential earthquake insurance policies, the Authority must provide full financial backing in accordance with a written plan of finance. The plan of finance must operate effectively to protect policyholders of the Authority's base-limits residential earthquake insurance policies from any financial liability arising from any offer of policy limits in excess of the base limits. The plan of finance may include the purchase by the Authority of reinsurance and financial guaranty insurance on terms and at the limits that the Authority may find reasonable and appropriate, to secure the payment of claims obligations and expenses that may arise under its optional-limits basic residential earthquake insurance policy and related contracts of reinsurance.

Upon the governing board's approval in a written finding of an appropriate plan of finance that will protect policyholders of the Authority's base-limits residential earthquake insurance policies from any financial liability arising from the sale or issuance of a basic residential earthquake insurance policy with limits in excess of the Authority's base-limits policies and which will neither rely on nor impair the Authority's available capital, as available capital is defined in Insurance Code section 10089.5, subdivision (b), the Authority may offer

the optional coverage types and coverage limits in paragraphs 1, 2, and 3, below, subject to the provisions of section 2697.4.

The optional coverage limits for Coverages C and D described in paragraphs 1, 2, and 3, below, are stated as gross limits that include the applicable base limits, and those portions of the gross limits that exceed the applicable base limits are to be written in excess of the base limits.

1. Dwelling Policy only: *Optional deductible amount for Coverage A, and additional eExcess contents (Coverage C), and additional living expense (Coverage D) limit options. The lowered policy deductible and increased limits for Coverage C and Coverage D may be offered in any of the following amounts (all limits that are expressed in this section as higher than base limits are to be written in excess of base limits, above, but are expressed below as gross limits that include the base limits):*

(i)	Coverage A (Dwelling) <i>Optional decreased deductible</i>	Equal to the Coverage A limit (or its equivalent limit) of underlying residential property insurance <i>10% of Coverage A limit</i>
	Coverage B	Not Available
(ii)	Coverage C (Contents)	\$25,000, \$50,000, \$75,000, or \$100,000
(iii)	Coverage D (Loss of Use)	\$10,000 or \$15,000
	Coverage E (Limited Building Code Upgrade)	\$10,000
(ii)	Coverage A (Dwelling)	Equal to the Coverage A limit (or its equivalent limit) of underlying residential property insurance
	Coverage B	Not Available
	Coverage C (Contents)	\$50,000
	Coverage D (Loss of Use)	\$10,000
	Coverage E (Limited Building Code Upgrade)	\$10,000

(iii)	Coverage A (Dwelling)	Equal to the Coverage A limit (or its equivalent limit) of underlying residential property insurance
	Coverage B	Not Available
	Coverage C (Contents)	\$75,000
	Coverage D (Loss of Use)	\$15,000
	Coverage E (Limited Building Code Upgrade)	\$10,000
(iv)	Coverage A (Dwelling)	Equivalent to the Coverage A limit (or its equivalent limit) of underlying residential property insurance
	Coverage B	Not Available
	Coverage C (Contents)	\$100,000
	Coverage D (Loss of Use)	\$15,000
	Coverage E (Limited Building Code Upgrade)	\$10,000

(v) ~~Option for 10% deductible for Dwelling Policy only: A 10% deductible option is available for all optional coverage limits combinations that are available for a dwelling, including base limits residential earthquake insurance policies. No 10% deductible option is available for condominium policies (including cooperative unit) or renter's policies. A dwelling policy that does not carry a 10% deductible must be issued at a 15% deductible. The Authority may determine administratively, through regular adoption of its plan of operations or policy forms, how to calculate and apply the deductible amount to losses incurred under Authority policies.~~

2. Individual Condominium and Cooperative Unit Policy only: Excess contents (*Coverage C*), and additional living expense (*Coverage D*) options, *which may be offered in any of the following amounts for Coverage C and Coverage D (all limits expressed in this section are to be written in excess of base limits, above, but are expressed below as gross limits including the base limits):*

(i)	Coverage A (Real Property)	\$25,000
	Coverage B	Not Available
	Coverage C (Contents)	\$25,000, \$50,000, \$75,000, or \$100,000
(ii)	Coverage D (Loss of Use)	\$10,000 or \$15,000
	Coverage E (Limited Building Code Upgrade)	\$10,000
	Coverage F (Loss Assessment (unit value > \$135,000))	\$50,000
	Coverage G (Loss Assessment (unit value < \$135,000))	\$25,000 or \$50,000
(ii)	Coverage A (Real Property)	\$25,000
	Coverage B	Not Available
	Coverage C (Contents)	\$50,000
	Coverage D (Loss of Use)	\$10,000
	Coverage E (Limited Building Code Upgrade)	\$10,000
	Coverage F (Loss Assessment (unit value > \$135,000))	\$50,000
	Coverage G (Loss Assessment (unit value < \$135,000))	\$25,000 or \$50,000
(iii)	Coverage A (Real Property)	\$25,000
	Coverage B	Not Available
	Coverage C (Contents)	\$75,000
	Coverage D (Loss of Use)	\$15,000
	Coverage E (Limited Building Code Upgrade)	\$10,000
	Coverage F (Loss Assessment (unit value > \$135,000))	\$50,000

	value > \$135,000))	
	Coverage G (Loss Assessment (unit value < \$135,000))	\$25,000 or \$50,000
(iv)	Coverage A (Real Property)	\$25,000
	Coverage B	Not Available
	Coverage C (Contents)	\$100,000
	Coverage D (Loss of Use)	\$15,000
	Coverage E (Limited Building Code Upgrade)	\$10,000
	Coverage F (Loss Assessment (unit value > \$135,000))	\$50,000
	Coverage G (Loss Assessment (unit value < \$135,000))	\$25,000 or \$50,000

3. Renter's Policy only: Excess contents (*Coverage C*) and additional living expense (*Coverage D*) options ~~for Coverage C and Coverage D may be offered in any of the following amounts (all limits expressed in this section are to be written in excess of base limits, above, but are expressed below as gross limits including the base limits):~~

(i)	Coverage A	Not applicable
	Coverage B	Not applicable
	Coverage C (Personal Property)	\$25,000, \$50,000, \$75,000, or \$100,000
(ii)	Coverage D (Loss of Use)	\$10,000 or \$15,000

(ii)	Coverage A	Not applicable
	Coverage B	Not applicable
	Coverage C (Personal Property)	\$50,000
	Coverage D (Loss of Use)	\$10,000
(iii)	Coverage A	Not applicable
	Coverage B	Not applicable
	Coverage C (Personal Property)	\$75,000
	Coverage D (Loss of Use)	\$15,000
(iv)	Coverage A	Not applicable
	Coverage B	Not applicable
	Coverage C (Personal Property)	\$100,000
	Coverage D (Loss of Use)	\$15,000

(f) For individual condominium unit policies and in accordance with its underwriting or eligibility guidelines, the Authority will issue earthquake loss assessment coverage in connection with its basic residential earthquake insurance policy for condominium owners in the amount of \$50,000.00 (fifty thousand dollars) for a unit valued at more than \$135,000.00 (one hundred thirty-five thousand dollars) and in the amount of \$25,000.00 (twenty-five thousand dollars) or \$50,000.00 (fifty thousand dollars) for a unit valued at \$135,000.00 (one hundred thirty-five thousand dollars) or less. The value of the land on which a unit is constructed is to be excluded when determining the value of the condominium unit.